Moving up a gear?

A survey of developments in the single market for asset management during 2003/04

Progress report 2003/04

Executive summary

- On 7 May 2003 Commissioner Bolkestein referred to the untapped potential of the single market: "it's as if we are driving a Ferrari in second gear". This document considers concrete recommendations as to how we might shift up a gear towards a single market for asset management.

- The document follows-up the publication of the Heinemann Report in May 2003, which made a number of recommendations to achieve a European single market for asset management. The Heinemann Report estimated that a single market for asset management would offer material economic benefits of at least €5 billion a year, or increase the final value of an average investor's pension by about 9%, or €120,000.

- This document surveys progress in 2003/04 towards a single market for asset management. The results of the survey indicate promising developments in that authorities are increasingly focussing on, and understanding the asset management industry. Despite some set-backs (such as inconsistent and anti-competitive implementation of the UCITS III Directive by certain Member States, and Belgium's new discriminatory tax regime) there have been a number of specific positive developments. For example, the survey highlights an industry-led initiative to agree pan-European standards for performance reporting of bond funds and progress in an industry-led initiative to establish common protocols for fund settlement.

- Nevertheless, much remains to be done and there is no room for complacency. IMA has identified three areas where further work should be prioritised: registration; mergers; and pooling. In each case, over the past year IMA has scoped the further work that needs to be performed, provided a cost benefit analysis, and identified appropriate future action (including non-legislative as well as legislative solutions). We intend to publish detailed reports on registration, mergers and pooling later in 2004.

- In addition, IMA intends to publish a recommendation on using private placement as a means of improving the single market and in particular supporting the European market for funds not at present harmonised at EU level (such as hedge funds).

- IMA is hopeful for the prospects of the single market for asset management. However, with so much work remaining to be done it is important to prioritise key issues. We hope this document will be considered a useful contribution to the prioritisation process.

The Heinemann Report

"The European asset management industry manages over € 10 trillion of assets – roughly the size of EU-15 GDP! This industry plays a vital macroeconomic role in Europe's economy. It contributes to fostering financial independence during working life-time and to sustaining a high quality of life also during retirement for European citizens. The asset management industry is also a driver of integrity and efficiency in European financial markets."

Financial Service Action Plan: Progress and Prospects
A report to the European Commission by the Asset Management Expert Group

In May 2003, the Investment Management Association (IMA[1]) published the 'Heinemann Report'[2] – an analysis of the benefits and barriers of a single European market for asset management, commissioned from an independent economics research institute.

The Heinemann Report estimated the benefits of a single European market for asset management to be in the range of 40 basis points (or 0.4%) on funds under management per annum[3]. Aggregated over time (as would be relevant in the case of pension savings products), such benefits are highly material: even assuming relatively modest investment growth, an extra 40 basis points a year could increase the asset value of a final pension by about 9%. What this means is that an individual who saved 10% of his salary throughout his working life could end up with a pension of about €120,000[4] more than would otherwise be the case.

With such material benefits to play for, the Heinemann Report also described the barriers – regulatory, fiscal and commercial – that inhibit the growth of the single market for asset management.

This document follows-up the publication of the Heinemann Report. It describes work that has been undertaken by IMA and others in the intervening period to remove the barriers to the single market, and commits to further output over the next year.

[1] The Investment Management Association (IMA) is the trade body for the UK-based investment management industry. IMA's members provide investment management services to institutions and private investors through individual fund management agreements and pooled products such as authorised investment funds. Between them, IMA's members manage some €2,800 billion worth of assets in the UK of which €1,265 billion is for non-UK clients. They manage €6,467 billion worldwide.
[2] Heinemann et. al, *Towards a single European market in asset management,* Zentrum fur Europaische Wirtschaftforschung, 2003 (www.investmentuk.org/research/default.htm). The report was commissioned and co-funded by IMA and the Corporation of London.
[3] For example, SEC Report on Mutual Fund Fees and Expenses, 2001
[4] This is based on a 25-year-old earning €45,000, contributing ten per cent per annum for forty years, with a salary growth rate of four per cent per annum, and a fund growth rate of seven per cent. Regardless of the assumptions upon which this calculation is based the difference is roughly constant in percentage terms.

Surveying progress towards the single market

The Heinemann Report made eleven recommendations to remove barriers to the single market for asset management.

IMA has surveyed progress on each of the eleven recommendations over the year since publication of the Heinemann Report. The results are set out in Appendix A.

The results of the survey indicate promising developments in that authorities are increasingly focussing on, and understanding the asset management industry. Despite some set-backs (such as inconsistent and anti-competitive implementation of the UCITS III Directive by certain Member States, and Belgium's new discriminatory tax regime) there have been a number of specific positive developments. For example, the survey highlights an industry-led initiative to agree pan-European standards for performance reporting of bond funds and progress in an industry-led initiative to establish common protocols for fund settlement.

A very significant development was the report of the Expert Group on Asset Management[5] (which was appointed by the European Commission to advise on the strengths and weaknesses of the EU framework of financial legislation, and identify future policy priorities). There is a significant overlap between the recommendations of the Expert Group Report and the Heinemann Report. To the extent that the European Commission and the asset management industry can agree a common policy agenda, there is real hope that progress toward the single market will pick-up speed.

In particular, both the Heinemann Report and the Expert Group Report emphasise the need for better enforcement and more consistent implementation of existing legislation. This will be all the more relevant as the Financial Services Action Plan passes to national authorities for local transposition and enforcement. Further level 2 and 3 guidance is pending on key measures (such as the Markets in Financial Instruments Directive). Notwithstanding the importance of implementation, both the Heinemann Report and the Expert Group Report also identify a number of concrete areas where further action may be required to promote the single market for asset management.

Also, both reports recognise that a large number of parties are responsible for achieving the single market for asset management – not just European legislators, but also the asset management industry and its trade associations, CESR[6] and national regulators. Hence the importance of industry-led initiatives to develop the single market, such as the agreement of pan-European standards for fund categorisation and common protocols for fund settlement mentioned above.

IMA is playing its part. As well as surveying progress on the Heinemann recommendations, IMA has also resolved to take an active role in their promotion and realisation.

Specifically, IMA intends to champion a number of the recommendations of the Heinemann Report. Owing to resource constraints, it is not possible to champion all of the recommendations, and therefore IMA (under the guidance of its European Strategy Committee, comprising executives from asset management firms with significant cross-border business) decided to prioritise recommendations against the following criteria:

---

[5] http://europa.eu.int/comm/internal_market/en/finances/actionplan/stocktaking.htm

[6] The Committee of European Securities Regulators ('CESR')

- **Importance**. The recommendations should be prioritised according to their importance in promoting the single market.

- **Feasibility**. The recommendations should be prioritised according to their feasibility.

- **Exclusivity**. The recommendations should be prioritised according to whether they are already being pursued by other parties (e.g. work on fund categorisation mentioned above) or are not yet on the policy agenda at all.

Using these criteria, IMA has prioritised three recommendations from the Heinemann Report: registration; mergers; and pooling. In each case, over the past year IMA has scoped the recommendation, estimated the costs and benefits associated with its resolution, and identified appropriate future action (including non-legislative as well as legislative solutions). We will publish detailed reports on registration, mergers and pooling later in 2004.

IMA has also begun to consider whether and how to support the development of a European single market for 'alternative' investment products (such as hedge funds). We concur with the Expert Group Report which noted:

> *"Whilst the UCITS legislation has spearheaded the development of a European asset management business, it is questionable whether its detailed product focused approach is always flexible enough to cope with the level and speed of product innovation that characterises the [alternative investment management] industry. The regulatory system therefore might need to find new approaches to reflect the dynamic nature of this business if it is to facilitate an effective and sound organisation on a pan-European basis."*

IMA believes that harmonising *private placement regimes* would provide such a 'new approach' to regulation and a complementary single market framework to the UCITS Directive. Consequently, we intend to undertake a survey of existing private placement regimes with a view to recommending what a future harmonised regime might look like.

Later in 2004, IMA will publish detailed reports on registration, mergers and pooling, which are briefly summarised below.

In addition, IMA will publish recommendations on using convergence of private placement regimes as a means of developing the single market in investment management.

Fund registration

Article 46 of the UCITS Directive requires investment managers to register their UCITS with regulators in each state in which they are marketed.

On the face of things, the registration process described in the Directive does not appear to be particularly onerous, comprising the provision of certain information which regulators must respond to within two months. However, a report by PricewaterhouseCoopers and FEFSI[7] notes that a number of Member States impose information obligations beyond those stipulated in the directive, and considerable time delays are often experienced in the approval process. Consequently, the registration process differs significantly between Member States.

Consequently, the registration process can be extremely expensive and time consuming. A member firm of IMA recently reported having to spend in excess of €100,000 to register its umbrella UCITS in one particular Member State. Indeed, the costs and risks of failing to upkeep registration are so significant that a number of service providers have gone to the lengths of developing systems to help investment managers manage the process and risks.

Did the UCITS Directive intend that registration should be so problematic? The original Directive was premised on investment managers making *direct* sales of UCITS to the general public. Consequently, the registration process was intended to satisfy the legitimate interest of regulators in understanding the marketing plans of the investment managers. However, in actual fact direct sales are highly uncommon – investment managers predominantly sell UCITS *indirectly* through third party distribution networks, such as banking, insurance and IFA networks, and funds of funds platforms. Since those third party distributors are primarily responsible for marketing the UCITS and subject to local marketing rules, it is hard to understand the market failure that the registration process is supposed to correct, and therefore hard to justify the expense.

Indeed, the cost of registering UCITS in certain Member States is so high that the registration process itself is a source of market failure since it represents a barrier to entry by foreign investment managers. In economic terms, the cost of registration can be conceived as a tax on supply, increasing the cost and reducing the quantity of foreign investment funds brought to market.

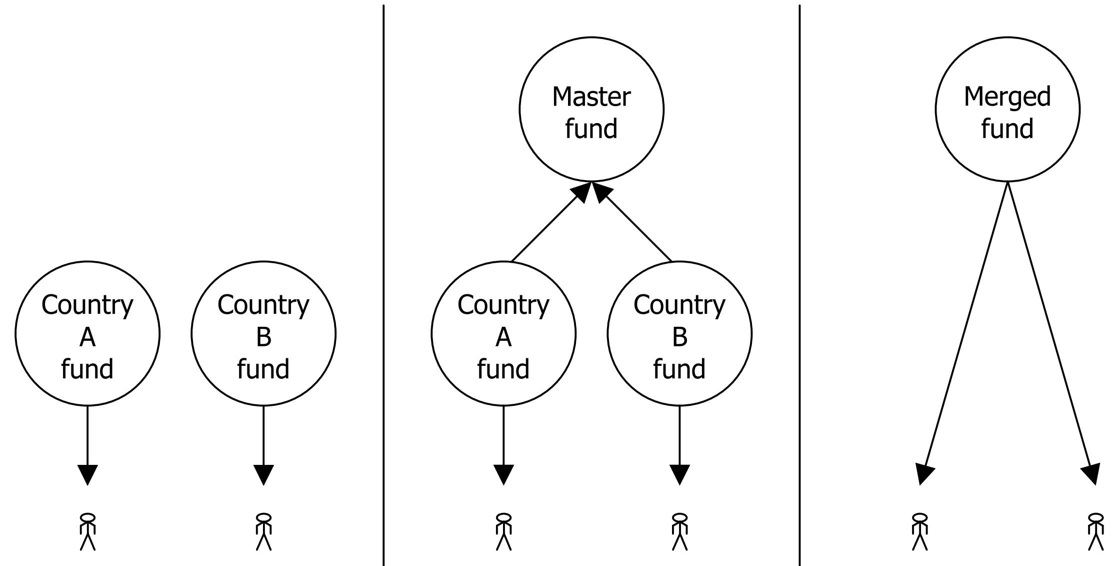
IMA therefore recommends the simplification or, better still, abolition of the registration requirement. We are in the process of collecting data from market participants on the cost and time of registering UCITS to support our recommendation. We intend to publish the data later in 2004, along with our thoughts on how the problem might best be addressed (for example, assisting CESR in its intention[8] to simplify the registration process).

[7] Cross-border marketing of "harmonised" UCITS in Europe, 2001
[8] CESR/04-160 Mandate for the Expert Group on Asset Management

Fund mergers and pooling

The Heinemann Report observed that the average size of investment funds in Europe is significantly lower than in the USA. Because investment management is characterised by economies of scale, this means that the European single market for asset management has not been able to achieve the cost efficiencies of its US counterpart. The Heinemann Report estimated annual costs savings of €5 billion per annum if the European asset management industry were able increase average fund sizes and achieve similar economies of scale to those enjoyed in USA.

The average size of investment funds in Europe is low because the absolute number of funds marketed to the public is high. Why does the number of investment funds proliferate in the EU, and what can be done about it? Our analysis identifies two reasons for the proliferation of investment funds, and two different remedies: pooling and fund mergers.



Offering multiple fund ranges increases administrative costs and decreases economies of scale…

Pooling allows multiple fund ranges to be managed *as though* they were one, increasing economies of scale…

Merging funds minimises administrative costs and maximises economies of scale.

Pooling

In some circumstances, cultural, commercial or regulatory factors *necessitate* the proliferation of investment funds.

For example, if consumers in country A and country B have a cultural preference for locally domiciled investment funds, then an investment manager will have little choice but to establish a fund range in each of those countries if it wishes to compete in those markets. Or if fiscal rules in the two countries discriminate against foreign investment funds or are fundamentally different, then, notwithstanding recent case law from the European Court of Justice, an investment manager will have to establish two fund ranges.

In such circumstances, pooling would allow investment managers to mitigate the cost of maintaining duplicative investment funds: pooling.

'Pooling' refers to arrangements and processes for the collective management of investment funds. Different pooling techniques allow separate fund ranges to be collectively managed either by feeding their assets into a master fund ('entity pooling') or by using information technology to allow the separate fund ranges to be managed *as if* they were a single range ('virtual pooling').

The European Federation for Retirement Provision estimated that the benefits of pooling (which is relevant to pension funds as well as investment funds) to be €1,200,000 per annum for the average European multi-national corporation[9]. These savings come from a variety of sources, including:

- Custody (larger pools are able to negotiate lower custody fees);
- Brokerage (larger transactions lead to lower unit cost);
- Netting transactions (with more sources coming into the pool the ability to net flows and reduce transaction costs will increase); and
- Administration costs (which are normally transaction based and will therefore be lower in basis point terms if the pool of assets is larger).

Pooling is permitted within certain member states of the European Union. For example, Spain, Luxembourg and Germany all have regulations which permit (in varying ways and to varying degrees) the pooling of investment funds. However, in the absence of a suitable regulatory framework, it is difficult to pool the assets of European investment or pension funds on a cross-border basis.

IMA therefore recommends that the EU develop a framework for cross-border pooling.

We have convened an expert group to scope the various extant pooling techniques, identify the benefits and barriers to pooling, and consider what legislative/non-legislative instruments might be required to enable pooling. The expert group will publish its findings later in 2004.

Fund mergers

In some circumstances investment managers may seek to reduce the number of investment funds in their portfolio, both domestically and on a cross-border basis. We offer two examples. When an investment management firm buys another firm, or acquires its product range, it is likely that the acquiring company will want to rationalise the combined product range, in particular by merging duplicate investment funds. Or, when an investment management firm launches a new investment fund that proves unsuccessful, or fails to reach critical mass, it may wish to merge that fund into its existing product range with a view to cutting costs. However, in both cases, the absence of a legislative framework for merging investment funds on a cross-border basis has effectively prevented fund rationalisation, variously because of regulatory barriers, discriminatory tax treatment or merely owing to the excessive costs of achieving a merger.

[9] "A European Institution for Retirement Provision" (European Federation for Retirement Provision, July 2000)

This lack of a framework for merging investment funds causes the proliferation of funds, which in turn increases transaction costs (i.e. the cost of administering multiple investment funds) and therefore causes market failure.

The institutions of the European Union clearly understand and support the economic argument for allowing cross-border mergers, since they are currently negotiating a Directive to enable cross-border mergers between companies[10]. Although in principle there is no reason why investment funds should not be included in that directive (since in both cases the aim is a merger of the economic capital of entities with a similar legal structure that holds the business), it would need substantial additional drafting to achieve the necessary result. IMA strongly recommends that the EU should promptly develop a framework for cross-border mergers of investment funds, whether through the Tenth Company Law Directive or through another legislative vehicle.

We have convened a group of market participants and legal and accounting experts to consider the issues arising and to pool information on barriers encountered. We propose to publish the findings of the group later in 2004, together with recommendations as appropriate.

[10] COM(2003) 613 final

Appendix A

A survey of progress toward the Heinemann recommendations

In 2003, the IMA published a position paper to accompany the Heinemann Report. The position paper made eleven recommendations to help realise the vision of single market for asset management.

The recommendations emphasise better enforcement and more consistent interpretation of existing legislation. They do not call for significant new legislation (although some existing legislation may require amendment). Neither are they intended to be prescriptive or complete. Contributions and refinements are invited from other interested parties.

IMA has surveyed progress on each of the eleven recommendations over the year since publication of the Heinemann Report, as described below.

Recommendation	Action
Fund registration Once a UCITS has been registered as such in its home state, there should be no need for further registration in all of the host states in which it is marketed. See above.	Member States and Commission
Fund mergers National fiscal and regulatory regimes should not discriminate against cross-border fund mergers. For example, if, say, a Luxembourg domiciled fund merges with a French domiciled fund, then Luxembourg should impose no greater regulatory requirements than if the merger occurred onshore. Similarly, if, say, a Swedish domiciled fund merges with a German domiciled fund, then Sweden should assess tax in the same way as if the merger occurred onshore. See above.	Member States and Commission
Pooling Fiscal, regulatory and commercial obstacles to cross-border 'pooling' of assets should be removed. See above.	Industry, Member States and Commission
Tax discrimination National fiscal regimes should not discriminate between domestic investment funds and offshore investment funds. • ***Belgian tax reform***. A new Belgian law came into force from 1 January 2004, subjecting subscriptions in a foreign investment fund made through a Belgian financial intermediary to a tax of 0.06%. The purported intention of the law is to level the playing field between Belgian investment funds (which are subject to taxe d'abonnement of	Industry, Member States and Commission

Recommendation	Action
0.06%) and foreign investment funds. However, there are a number of aspects of the tax which appear to be discriminatory, and FEFSI has brought this matter to the attention to the European Commission. • ***German tax reform***. The German Investment Tax Act reforms came into effect from 1 January 2004. Whilst those reforms have repealed the previous discriminatory treatment of distributions by foreign investment funds, they have introduced a new form of discrimination; tax relief is now provided for German investors on the merger of German domiciled funds, but not on the merger of foreign domiciled funds. We understand that the German Ministry of Finance are aware of this issue and are hoping to amend the law in due course. • ***UK tax reform***. The UK Finance Bill, which was published on 8 April 2004, removed a number of discriminatory provisions against foreign investment funds. In particular, foreign domiciled umbrella funds can now launch individual sub-funds which are compliant with UK tax requirements without being 'tainted' by other non-compliant sub-funds within the same umbrella. The Finance Bill awaits Royal Assent later in the year. • ***EU communication***. The European Commission published a communication on dividend taxation on 8 January 2004 which identified various cases of discrimination in the taxation of dividend income. The communication was concerned that such discrimination might distort investment decisions and impede the free movement of capital within the Union. Unfortunately, the communication did not consider the effect on the taxation of dividend taxation of interposing an intermediate vehicle (such as an investment, pension or life fund) in between the investor and the underlying security, despite this being the most common way that retail investors expose themselves to foreign financial securities. Therefore the Communication's analysis of tax impediments to the free movement of capital is incomplete.	
Infrastructure Infrastructure providers (particularly transfer agents) should standardise the protocols required to process the buying and selling of shares in investment funds, in order to reduce the complexity (and costliness) of cross-border business. Initially, further analysis is required to describe the various processes undertaken by different infrastructure providers, and identify opportunities to standardise those processes. • ***Funds settlement***. FEFSI has established a Funds Processing Standardization Group. The objective of the Group is to define, approve, develop or mandate development of pan-European standards relevant to the whole complex of order processing of investment funds – including communication standards and business practices (portfolio statement, product comparison, tax reporting, investor communication, etc.). The Group is comprised of expert/practitioners representing the European investment funds industry. The main players in the European investment funds industry, i.e. fund management companies, distributors, custodians, transfer agents, fund processing hubs (e.g. Fundsettle and Vestima) and participants in existing standard setting working groups (e.g. SWIFT, ISITC, ...) are associated with the initiative.	Industry

Recommendation	**Action**
Public data Asset managers should standardise the calculation and publication of data on fund classification and performance, costs and financial statements, in order to increase the comparability of investment funds. • ***Performance reporting***. At the end of 2002 a group of leading European Asset Management Companies formed the European Fund Categorisation Forum with the leading data providers. The prime objective of the group is to enable customers throughout Europe to compare investment fund performance of investment funds offered on a cross-border basis on a like-for-like basis based on robustly constructed and implemented rules. During 2003 the Group defined the rules for Fixed Income funds since this was where the need to improve consistency was felt to be greatest. The categorisation for Fixed Income is now complete based on three core differentiation principles of maturity, currency and credit quality. In 2003 the group engaged with FEFSI to ensure European level and local country trade association support. This partnership has been highly effective in getting the initial fixed income categories defined and approved. Certain local associations are already looking to adopt this as their national standard. The work for 2004 is now focused on implementing the fixed income sectors using an approach based on the IMA Performance Category Review Committee methodology and on extending the sector definition work to cover equity funds. • ***Simplified prospectus***. The UCITS Contact Committee has issued recommendations which include a requirement for a fund to publish a Total Expense Ratio based on a recommendation from the industry.	Industry
Financial advisers The quality of financial advice should be improved by developing an industry-wide code of conduct/professional rules. This will benefit consumers in countries where the quality of advice could be improved. It will also benefit investment fund providers by increasing awareness of their products. It is also consistent with the Internal Market Strategy. • ***Market in Financial Instruments Directive***. The new Market in Financial Instruments Directive which updates the 1993 Investment Services Directive has brought investment advice within its scope. Investment firms providing investment advice within the EU will require authorisation and will be subject to the organisational and conduct of business rules set out in the level 1 directive and in the subsequent level 2 work. There is however an optional exemption included in the directive which allows for members states to choose not to apply the directive to certain firms providing investment advice in relation to units in collective investment undertakings and transferable securities provided these firms are regulated at national level. While this optional exemption may undermine some of the benefits of harmonised rules for investment advisers, the directive will ensure that investment advice will be subject at least to national rules, in many cases for the first time. • ***ISO standards***. The International Standards Organisation (ISO) has drafted comprehensive standards for personal financial planning, covering: 1. Definition and process of personal financial planning (draft ISO	Trade associations and national regulators

Recommendation	Action
21551); 2. Requirements for competence of a personal financial planner (draft ISO 21555); 3. Ethical requirements (draft ISO 15551); and 4. Experience requirements (draft ISO 23449) The draft represents a step forward in offering a higher standard than the regulatory benchmark and helps in identifying the essential elements of the financial planning discipline. The standard is the result of close cooperation between a wide range of industry and professional bodies both in the UK and internationally. The ISO standard is due to be introduced towards the end of 2005. • ***FEFSI high level principles for fund distribution***. In September 2003, FEFSI convened an expert group to "define, develop or mandate development and formulate draft European high level principles concerning the distribution of publicly distributed and regulated investment funds". Although FEFSI has no jurisdiction over financial advisers, and these principles will therefore be directed towards national associations of investment management firms, it is nevertheless hoped that they will help improve the quality of advice in fund distribution through co-operation with distributors.	
Industry data The volume and quality of data about the activities of the investment management industry should be increased. This will help policy makers establish milestones for the single market for asset management and monitor progress towards those milestones. It will also help asset management firms develop an effective European strategy.	Industry and Commission
The regulatory environment The regulatory environment needs to be simplified, in particular by: co-ordinating the interpretation of Directives by national regulators; and co-ordinating the drafting of Directives by the Commission. • ***The UCITS Directive***. Responsibility for implementing the UCITS amending Directives ('UCITS III') has been transferred from the UCITS Contact Committee to the Committee of European Securities Regulators ('CESR'). This is to be welcomed, in particular because CESR is likely to prove to be more transparent and effective in its workings that the Contact Committee. CESR inherits a lot of issues to address, and has been consulting how to go about them, including: product grandfather and grace periods; notification requirements; the scope of permissible activities of management companies during the transitional period; and clarification of definitions. • ***Other directives***. CESR has also recognised the interest of the asset management industry in other directives such as the Markets in Financial Instruments Directive, E-Commerce Directive and Distance Marketing Directive.	Commission and CESR and Member States

<table>
<tr><th>Recommendation</th><th>Action</th></tr>
<tr><td>

Industry representation

The asset management industry needs to improve and unify its representation at the highest levels in the EU, to ensure that legislation is appropriate to the asset management industry as a whole, so that the interests of the 'buy side' are fully understood.

- ***FEFSI-EAMA merger***. The hoped for merger of FEFSI and EAMA has not occurred but we continue in discussion to strengthen the representation of the industry at a European level.

</td><td>Trade associations</td></tr>
<tr><td>

Consumer protection

Appropriate levels of consumer protection need to be agreed and facilitated for cross-border business.

- ***FEFSI code of conduct***. FEFSI is drafting a code of conduct to be addressed to national asset management trade associations, which represents an initiative by the European investment management industry to build-up its leadership role and aims to preserve and strengthen:

    1. The integrity of the European market-place for investment management and its worldwide reputation;
    2. The confidence of investors in the "investment management service" and the existing high level of investor protection;
    3. High standards for authorised investment managers – so that they are best equipped to manage money on a fiduciary basis.

    The Code sets forthe high-level principles, which FEFSI regards as key elements of good conduct.

</td><td>Commission and national regulators</td></tr>
</table>